United States Court of Appeals

for the Second Circuit

APPELLANT'S BRIEF

ORIGINAL

77-6095

To be argued by
VICTOR S. GOMPERTS

In The

United States Court of Appeals

For The Second Circuit

AMERICAN TELEPHONE AND TELEGRAPH COMPANY,
Plaintiff-Appellant,

-against-

THE UNITED STATES OF AMERICA,
Defendant-Appellee.

Appeal from the United States District Court for the Southern District of New York.

BRIEF FOR PLAINTIFF-APPELLANT

FRANK L. FULLER III
VICTOR S. GOMPERTS
Attorneys for Plaintiff-Appellant
195 Broadway
New York, New York 10007
(212) 393-4083

UNITED STATES COURT OF APPEALS
FILED
AUG 2 1977
A. DANIEL FUSARO, CLERK
SECOND CIRCUIT

10921

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UNITED STATES COURT OF APPEALS

FOR THE SECOND CIRCUIT

Docket No. 77-6095

AMERICAN TELEPHONE AND TELEGRAPH COMPANY,

Plaintiff-Appellant,

- against -

THE UNITED STATES OF AMERICA,

Defendant-Appellee.

APPEAL FROM THE UNITED STATES DISTRICT COURT
FOR THE SOUTHERN DISTRICT OF NEW YORK

BRIEF FOR PLAINTIFF-APPELLANT

Plaintiff-appellant American Telephone and Telegraph Company ("AT&T") appeals from a judgment entered on April 18, 1977 by the United States District Court for the Southern District of New York, Carter, J., granting defendant-appellee's motion for summary judgment. The District Court's opinion here under review (24A - 32A)* is

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*Page citations followed by "A" are citations to the Appendix filed with this Court on this appeal.

dated April 15, 1977. It is reported at 430 F. Supp. 172 (1977).

ISSUES PRESENTED

1. Did the Court err in interpreting section 905(c) of the Internal Revenue Code to require that the credit for a tax, which had been paid to Canada and had been claimed in a U.S. return, must be reduced by the amount of gain on Canadian currency resulting from fluctuation in exchange rates between the time of payment and subsequent refund of a Canadian tax imposed after the return had been filed upon a transaction entirely separate from the one which had given rise to the tax claimed as credit in the return?

2. Even if the result reached by the Court was a permissible interpretation of section 905(c), did the Court err, nevertheless, in not interpreting an ambiguous tax provision in a manner which would encourage taxpayers to minimize their foreign tax liability thereby increasing Federal revenues?

STATEMENT OF THE CASE

In 1972, AT&T received from Canada a refund of a 1964 tax which had been assessed and paid in 1967. The dollar value of the refunded tax at time of refund exceeded the dollar value of the tax when originally paid. This litigation arises because the Internal Revenue Service ("IRS"), upon refund to

AT&T of the contested Canadian tax, applied section 905(c) of the Code incorrectly in redetermining AT&T's tax liability for the year 1964 in that the IRS reduced an unrelated and valid foreign tax credit claimed by AT&T in its 1964 tax return by the amount of Canadian currency gain realized on the refund.

On February 4, 1976, AT&T filed its complaint ..king a tax refund of $69,381.50 plus interest against the United States.

AT&T and defendant both mov.d for summary judgment and oral argument was held on January 28, 1977. On April 15, 1977, the District Court rendered an opinion granting summary judgment in favor of defendant. Although noting that "it is not amiss to point out what appears to be a sound policy argument to the contrary" (28A), the District Court held that defendant's interpretation of section 905(c) of the Code was correct. The Court explained the "sound policy argument" which supports AT&T's position by conceeding that the Court's interpretation of section 905(c):

> "... gives to a U.S. taxpayer who has paid a foreign tax which has been credited against his United States tax no incentive to seek any refund from the country, since whatever he receives must be handed over in full to the IRS. The virtue of ATT's proposed reading of § 905(c), on the other hand, is that a U.S. taxpayer would have an incentive to seek refund of a foreign tax since any gain resulting from an exchange rate fluctuation would be taxed only as a capital gain or ordinary income, and the taxpayer would be able to retain some portion of the refund . . . [w]ere this

the rule both the Government and the taxpayer would gain. At present, however, a taxpayer has no incentive to seek such a refund, as it is of no import to him, absent unusual patriotic impulses, since he stands to gain nothing for his efforts." (28A - 29A)

Plaintiff filed a Notice of Appeal on June 8, 1977 (34A).

STATEMENT OF FACTS

AT&T's 1964 tax return, as filed on September 15, 1965, claimed a foreign tax credit of $269,085.10 for Canadian taxes withheld at source by Canadian companies because of their payment to AT&T in 1964 of interest and dividends which are taxable under the Canadian Income Tax Act. The dividend and interest payments were taxed under section 106(1)(a) and 106(1)(b), respectively, of the Canadian Income Tax Act, and taxes withheld pursuant to section 109 of the Canadian Income Tax Act (19A). The $269,085.10 of withheld tax has never been refunded to AT&T by Canada, nor has a refund ever been sought.

On January 11, 1967, Canada assessed against AT&T an additional $763,272.90 (Canadian dollars) tax for the year 1964 pursuant to section 106(1)(d) of the Canadian Income Tax Act. Canada asserted that the assessed tax was owed by AT&T because a Canadian company had failed to withhold tax at source on certain fees paid to AT&T in 1964 pursuant to a service agreement (19A).

Although AT&T disagreed with the validity of the Canadian tax assessment, on January 23, 1967 it paid to Canada $763,272.90 (Canadian dollars), and proceeded to contest the assessment. The United States dollar value of the Canadian tax payment according to the rate of exchange on January 23, 1967 was $707,859.29. Subsequently, in 1969, the IRS credited AT&T's 1964 tax liability by $707,859.29 to reflect the payment by AT&T of the Canadian tax assessment (19A - 20A).

In late 1972, Canada reversed the 1967 tax assessment and refunded to AT&T, on October 26, 1972, all of the tax which was wrongfully assessed against, and paid by, AT&T in 1967 (20A). On October 26, 1972, because of exchange rate fluctuation, the tax refund of $763,272.90 (Canadian dollars) had an equivalent United States dollar value of $777,240.79, which is $69,381.50 more than the amount by which AT&T's tax liability for 1964 had been reduced to reflect its payment of the invalid tax assessment in 1967 (20A).

On November 6, 1972, pursuant to section 905(c) of the Code, AT&T notified the IRS of its receipt of the Canadian tax refund (21A). The IRS thereupon redetermined AT&T's income tax due for 1964 by (i) reversing the credit of $707,859.29 which was originally allowed in order to reflect the payment by AT&T of the contested tax assessment and (ii) reducing the $269,085.10 foreign tax credit claimed on AT&T's original tax return by $69,381.50 - the amount of gain from the exchange rate fluctuation (21A). The net effect of this adjustment was to reduce the foreign tax credit AT&T claimed on its

original tax return from $269,085.10 to $199,703.60

ARGUMENT

POINT I

SECTION 905(c) OF THE INTERNAL REVENUE CODE CANNOT BE INTERPRETED IN A MANNER THAT RESULTS IN A PARTIAL DISALLOWANCE OF A FOREIGN TAX CREDIT WHICH WAS VALIDLY CLAIMED ON AT&T'S 1964 TAX RETURN

A. A PORTION OF THE FOREIGN TAX CREDIT CLAIMED ON AT&T'S TAX RETURN WAS IMPROPERLY DISALLOWED

The District Court held that a portion of AT&T's foreign tax credit which was claimed on its original tax return should be disallowed because of the subsequent refund to AT&T of a contested Canadian tax which had a higher United States dollar value when refunded, due to a currency fluctuation, then when originally paid to Canada.

Section 901(a) of the Internal Revenue Code provides that a taxpayer may elect to receive a credit against its tax liability for taxes paid to a foreign country to the extent provided in section 901(b). Section 901(b) reads as follows:

> "(b) Amount Allowed. - Subject to the applicable limitation of section 904, the following amount shall be allowed as the credit under subsection (a):
>
> (1) Citizens and domestic corporations. -- In the case of a citizen of the United States and of a domestic corporation, the amount of any income, war profits, and excess profits taxes paid or accured during the taxable year to any foreign country or to any possession of the United States;..."

Under the clear statutory authority of section 901, AT&T chose to claim a credit in its 1964 tax return for $269,085.10, the amount of tax withheld at source in Canada in 1964 on the payment of taxable dividends and interest. There are only two circumstances - neither of which have occured - that could cause AT&T to forfeit any portion of the $269,085.10 foreign tax credit it chose to claim in its 1964 tax return. These two circumstances are set forth in section 905(c) of the Code:

> "(c) Adjustments on Payment of Accrued Taxes. -- If accrued taxes when paid differ from the amount claimed as credits by the taxpayer, or if any tax paid is refunded in whole or in part, the taxpayer shall notify the Secretary, who shall redetermine the amount of the tax for the year or years affected ..."

Since AT&T neither accrued its tax liability to Canada in an amount different from the amount claimed as a credit, nor was any portion of the $269,085.10 Canadian tax on dividends and interest refunded in whole or part, the redetermination provision of section 905(c) is not applicable. Accordingly, AT&T's 1964 foreign tax credit of $269,085.10 must be allowed to stand as claimed.

The District Court's interpretation of section 905(c) leads to a disallowance of a portion of the $269,085.10 foreign tax credit claimed by AT&T in its 1964 tax return. This result is squarely at odds with the principle underlying the foreign tax credit provisions of the law, i.e., relief from international

double taxation. Under the income tax law of the United States, AT&T is taxed on its world-wide income. Thus, regardless of its geographical source, the entire income of AT&T is subjected to the United States income tax. If the income is also taxed by the foreign country in which it originates, the problem of international double taxation arises. While some other devices are used by the United States to relieve the burden of international double taxation, the most important relief is that provided by the foreign tax credit. Owens, The Foreign Tax Credit (1961) § 1/1.

In 1964, AT&T paid $269,085.10 of tax to Canada on its receipt of taxable dividends and interest. The receipt of the dividends and interest were also reported by AT&T in its 1964 United States tax return. But for the foreign tax credit of $269,085.10 claimed by AT&T in its 1964 tax return, AT&T would have been taxed twice on the dividends and interest: once by Canada and once by the United States. The effect of the District Court's determination that AT&T's $269,085.10 foreign tax credit should be reduced by $69,381.50 is to subject the Canadian dividend and interest payments to $69,381.50 of United States tax. This is clearly double taxation, as the dividends and interest were already fully taxed by Canada.

The only Canadian tax that was refunded, thus bringing into play the provisions of section 905(c), was the contested tax payment made pursuant to the improper assessment

received by AT&T in 1967. The United States dollar value of the contested tax payment, at time of payment, was $707,859.29. When the contested tax was refunded to AT&T in 1972, it had a United States dollar value of $777,240.79, or $69,381.50 more than the value of AT&T's payment to Canada in 1967. The proper application of section 905(c) to the unique facts presented by this refund will be developed in POINT I(B), (C) and (D) below. In sum, we submit that the entire episode involving the contested 1967 Canadian tax assessment, tax payment, refund claim and ultimate refund - events which all occurred long after the AT&T's 1964 tax return was filed - should in no way affect the $269,085.10 foreign tax credit originally claimed in the tax return.

B. THE INCREASE IN AT&T'S 1964 TAX LIABILITY, RESULTING FROM THE REFUND OF THE CONTESTED CANADIAN TAX, CANNOT EXCEED THE DOLLAR VALUE OF THE CONTESTED TAX WHEN ORIGINALLY PAID

If a taxpayer's income tax liability is reduced to reflect payment of a foreign tax (albeit contested), and the foreign tax is subsequently refunded in whole or in part, section 905(c) provides that the amount of tax for the year affected shall be redetermined. Section 905(c) reads as follows:

> "(c) Adjustments on Payment of Accrued Taxes. - If accrued taxes when paid differ from the amounts claimed as credits by the taxpayer, or if any tax paid is refunded in whole or in part, the taxpayer shall notify

> the Secretary, who shall redetermine the amount of the tax for the year or years affected. The amount of tax due on such redetermination, if any, shall be paid by the taxpayer on notice and demand by the Secretary, or the amount of tax overpaid, if any shall be credited or refunded to the taxpayer in accordance with subchapter B of chapter 66 (sec. 6511 and following). In the case of such a tax accrued but not paid, the Secretary, as a condition precedent to the allowance of this credit, may require the taxpayer to give a bond, with sureties satisfactory to and to be approved by the Secretary, in such sum as the Secretary may require, conditioned on the payment by the taxpayer of any amount of tax found due on any such redetermination; and the bond herein prescribed shall contain such further conditions as the Secretary may require. In such redetermination by the Secretary of the amount of tax due from the taxpayer for the year or years affected by a refund, the amount of the taxes refunded for which credit has been allowed under this section shall be reduced by the amount of any tax described in section 901 imposed by the foreign country or possession of the United States with respect to such refund; but no credit under this subpart, and no deduction under section 164 (relating to deduction for taxes) shall be allowed for any taxable year with respect to such tax imposed on the refund. No interest shall be assessed or collected on any amount of tax due on any redetermination by the Secretary, resulting from a refund to the taxpayer, for any period before the receipt of such refund, except to the extent interest was paid by the foreign country or possession of the United States on such refund for such period."

The language of section 905(c) yields no clue whatsoever as to the proper method for making a redetermination upon the refund of a foreign tax.

The regulations promulgated under section 905(c) are equally devoid of any guidance as to the proper method for making the required redetermination. Regulation § 1.905-3(a) reads as follows:

> "Redetermination of the tax when credit proves incorrect. (a) In General. In case credit has been given for taxes accrued, or a proportionate share thereof, and the amount that is actually paid on account of such taxes, or a proportionate share thereof, is not the same as the amount of such credit, or in case any tax payment credited is refunded in whole or in part, the taxpayer shall immediately notify the Commissioner. The Commissioner will thereupon redetermine the amount of the tax of such taxpayer for the year or years for which such incorrect credit was granted. The amount of tax, if any, due upon such redetermination shall be paid by the taxpayer upon notice and demand by the district director. The amount of tax, if any, shown by such redetermination to have been overpaid shall be credited or refunded to the taxpayer in accordance with the provisions of § 301.6511(d)-3 of this chapter (Regulations on Procedure and Administration)."

As the statute and regulation are both silent on the proper method for applying section 905(c), the District Court's opinion relies solely on a ruling, Rev. Rul. 58-237, 1958-1 C.B. 534 (1958), issued by the defendant. This reliance is misplaced, however, for Rev. Rul. 58-237 does not reach the narrow issue presented in this litigation.

Under the facts of Rev. Rul. 58-237, a taxpayer paid an income tax in British pounds to the United Kingdom in 1944 and on his Federal income tax return claimed the dollar amount of such tax as a credit against his United States

income tax for that year. In 1954, he received a refund in British pounds of part of such income tax, at which time the rate of exchange for the British pound was less that it had been in 1944. He was required, by section 131(c) of the 1939 Code (the equivalent to section 905(c) in the 1954 Code), to report the amount of such refund in order that a redetermination might be made of the amount of credit allowable for 1944. The holding of the ruling reads as follows:

> "Held, in computing the dollar value of a refund of foreign income taxes for which a foreign tax credit had been allowed, the rate of exchange in effect at the date of such refund should be used in converting the foreign currency in which the refund is paid into United States currency. The amount of tax paid for 1944 as redetermined will be the dollar amount of tax previously paid at the exchange rate then in effect, less the amount refunded converted into dollars at the exchange rate prevailing at the date of such refund." 1958 C.B. 534

The ruling stands for two propositions: (i) When the IRS makes a redetermination under section 905(c), based on a refund of a foreign tax, the dollar value of the refund used for the redetermination must be determined according to the exchange rate at the time of the refund. (ii) The amount of tax allowed to stand as a foreign tax credit after a foreign tax refund will be "the dollar amount of tax previously paid" minus the amount refunded.

In issuing Rev. Rul. 58-237, the IRS was ruling on a fact pattern quite different from the one presented in the

present case. Under the facts of the ruling, the rate of exchange for the British pound at the time of refund was less than it had been when the tax was originally paid. Therefore, the refund, in terms of United States dollars, was less than the foreign tax credit originally claimed. Thus, by subtracting the refund from the original credit, a proper redetermination is effected.

In the present case, the rate of exchange for the Canadian dollar at the time of refund was more than it had been when the tax was originally paid. Because the refund was a total refund of the contested Canadian tax, its United States dollar value was more than the value of the contested tax when originally paid. On these facts, it is impossible to simply subtract the value of the refund from the value of the original tax payment as it will result in a negative number ($707,859.29-$777,240.79 = -$69,381.50).

The ruling, therefore, has limited application. Its holding applies to a refund of a foreign tax, where the value of the refund does not exceed the value of the original credit. For example, assume that a taxpayer paid $1,000. (Canadian dollars) in Canadian tax at a time when the Canadian dollar and the United States were equal in value. A foreign tax credit of $1,000. would be allowed to taxpayer on its tax return. Further assume that Canada subsequently refunds 50% of the tax - $500. (Canadian dollars) - at a time when the Canadian dollar is worth $1.25. The refund

is valued as of the date of refund and is equal to $625. (500 Canadian dollars x $1.25). Under the holding of Rev. Rul. 58-237, the taxpayer's original foreign tax credit of $1,000. is reduced by $625., leaving a net foreign tax credit of $375. The Government is thus the beneficiary of the currency fluctuation, as the gain resulting from the currency fluctuation reduces the taxpayer's foreign tax credit dollar for dollar.

On the other hand, if in the above example the Canadian dollar was worth only $.90 at the time of the refund, the refund would be equal to $450. (500 Canadian dollars x $.90). Under the holding of Rev. Rul. 58-237, the taxpayer's original foreign tax credit of $1,000. is reduced by $450., leaving a net foreign tax credit of $550. On these facts, the taxpayer is the beneficiary of the currency fluctuation, as the loss resulting from the currency fluctuation is absorbed by the Government.

Thus, Rev. Rul. 58-237 equitably apportions between the Government and the taxpayer the risks of foreign currency fluctuations in situations where the value of the foreign tax refund does not exceed the original credit. In a case, such as the one before this Court, where the value of a foreign tax refund exceeds the value of a contested tax when it was originally paid, Rev. Rul. 58-237 offer no guidance as to the proper method of redetermination. Nor could it, as the ruling deals only with a decrease in exchange rates, not an increase.

In reliance on Rev. Rul. 58-237, the District Court held that a section 905(c) redetermination "should be made by subtracting from the original foreign tax credit the dollar value of the refund measured at the prevailing exchange rate on the day the refund is made" (27A). Although the Court's holding is sound, it erred in applying its own holding. The minuend in the above formula was determined by the Court to be an amount equal to the total of the foreign tax paid on dividends and interest in 1964 ($269,085.10) plus the contested tax payment ($707,859.29) or a total of $976,944.39. Once having determined the minuend to be $976,944.39, the Court simply subtracted the value of the tax refund ($777,240.79) from that amount.

The error in this approach is that the $269,085.10 foreign tax credit originally claimed in AT&T's tax return - an amount that has never been refunded - should not be included in the minuend. Rev. Rul. 58-237 defines the minuend as being "the dollar amount of tax previously paid." In the context of that ruling, the "dollar amount of tax previously paid" is equal to the foreign tax credit originally allowed on the subsequently refunded taxes. It does not include tax credits on unrelated foreign tax payments.

Limiting the minuend to the foreign tax credit originally claimed on the refunded tax has been the stated policy of the IRS since 1925. In S.M. 2243, IV-1 C.B. 231 (1925), the IRS considered how a redetermination of tax

liability was to be made under section 238(a) of the Revenue Act of 1918, 40 Stat. 1057*, following a refund of a contested foreign tax. The tax had originally been assessed against a corporation by the Cuban Government. The taxpayer contested the tax assessment and made application for its refund. The ruling holds that the taxpayer should be allowed a tax credit upon the payment of the contested tax and in the event of refund a redetermination will be made. The ruling describes the method of redetermination:

> "It is clear that the foregoing provision [section 238(a)] contemplates that credit should be given for the full taxes paid a foreign Government under such circumstances as exist in the instant case and for a redetermination of the credit in the event of a refund to the taxpayer by the foreign government of such taxes." IV-1 C.B. 232 (emphasis supplied)

This ruling is on all fours with the case before this Court for review. Upon the refund of a contested foreign tax, "the credit" claimed on the original payment of the contested foreign tax is redetermined. There is no indication that unrelated foreign tax credit should be considered as a part of the redetermination process. Based on this analysis, AT&T's 1964 tax liability should be increased by $707, 859.29. This would reflect the fact that in retrospect AT&T is not entitled to a credit in its 1964 tax return for the subsequently refunded Canadian tax. In this manner,

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*Section 238(a) of the Revenue Act of 1918 in substance is the same as section 905(c) of the Code.

the contested Canadian tax assessment and subsequent refund are placed in perspective vis-a-vis AT&T's 1964 tax return, i.e., they are treated as a series of events which cancel each other out and therefore have no effect on AT&T's 1964 tax liability.

C. THE EXCESS PORTION OF THE CANADIAN TAX REFUND IS INCOME TO AT&T IN THE YEAR OF RECEIPT AND IS CHARACTERIZED AS A FOREIGN CURRENCY GAIN

In general, the recovery by a taxpayer of an item previously deducted or credited in its tax return is taxable in full in the year of recovery, except to the extent the previous deduction or credit did not result in any tax benefit to the taxpayer. This rule is known as the "tax benefit rule" and it has been codified in section 111 of the Code. An amount equal to the portion of the items recovered, which were deducted or credited in a prior year without any reduction in income tax, is defined in section 111 as the "recovery exclusion". Amounts recovered in later years may be received tax-free to the extent of the recovery exclusion, but recoveries in excess of the recovery exclusion are included in income in the year of recovery.

Section 111 does not, however, govern the income tax treatment of the refund of foreign taxes previously credited, as section 905(c) preempts section 111 in that regard. In the absence of the mandate of section 905(c) to treat the refund of a previously credited foreign tax as

giving rise to an adjustment in the original year of credit, the entire refund of a contested foreign tax (which gave rise to a credit when paid) would be treated as a current year income item subject to a possible exclusion in whole or in part under section 111.

If section 111 applied to the entire refund of the contested Canadian tax, only $707,859.29 of the total refund of $777, 240.79, would be considered eligible for "recovery exclusion" treatment. It was the crediting of that amount which rise to a tax benefit in AT&T's 1964 tax return. However, because AT&T's 1964 tax liability was reduced by $707,859.29 to reflect the contested foreign tax payment, none of it would be eligible for "recovery exclusion" treatment. But for section 905(c), the recovery of the $707,859.29 which previously gave rise to a tax benefit when credited, would be treated as an income item in the year recovered. Section 905(c), however, preempts section 111 on foreign taxes previously credited and thus $707,859.29 of the total refund is treated as an upward adjustment to AT&T's 1964 tax liability (original year of credit) and not a current income item. The collection by AT&T at the time of refund of an additional $69,381.50, as a result of currency fluctuation, is not a refund of an item previously credited and is therefore not treated under section 905(c). Nor is the refund of $69,381.50 treated under section 111 as it was never deducted or claimed as a credit in the 1964 tax return and thus does

not have the potential to qualify for recovery exclusion treatment. This point is illustrated by an example in the regulations under section 111:

> "Furthermore, the term recovery does not include the gain resulting from the receipt of an amount on account of a section 111 item which, together with previous such receipts exceeds the deduction or credit previously allowed for such item. For instance, a $100 corporate bond purchased for $40 and later deducted as worthless is subsequently collected to the extent of $50. The $10 gain (excess of $50 collection over $40 cost) is not a recovery of a section 111 item. Such gain is in no case excluded from gross income under section 111, regardless of whether the $40 recovery is or is not excluded." Reg. § 1.111(a)(2).

If, as is permitted by section 164 of the Code, AT&T had deducted the $707,859.29 Canadian tax payment (rather than crediting the payment), section 905(c) would not apply at all to the subsequent refund. Section 111 would then have applied to that portion of the refund for which AT&T received a tax benefit by virtue of its deduction, i.e., $707,859.29; because this amount would fail to qualify for recovery exclusion treatment, it would be taxed as a current item. The balance of the refund, $69,381.50, would be a current income item under section 61 of the Code (which defines gross income), without reference to section 111.

The District Court, however, purports to treat the excess portion of the tax refund, which is solely attributable to currency fluctuation, as an item which did give rise to a tax benefit in 1964 by disallowing $69,381.50 of AT&T's 1964

foreign tax credit which was wholly unrelated to the refunded tax. This excess portion, however, is not an item of previously credited foreign tax subject to "recapture" by the Commissioner pursuant to a redetermination under section 905(c). Accordingly, the $69,381.50 excess refund is an item of current income under section 61 in accordance with Reg. § 1.111 (a)(2), and is properly characterized as a foreign currency gain. This is sound because the excess refund is due to a fluctuating currency rate from 1967 to 1972. The treatment of gains resulting from foreign currency fluctuation, in this manner, has been recognized as correct by the IRS and the Courts.

In Rev. Rul. 74-7, 1974-1 C.B. 16, a United States taxpayer traveling in a foreign country deposited dollars in a bank in that country. At his request, the bank converted these dollars to the country's currency for the taxpayer's personal use. The taxpayer was not a dealer in foreign currency and was not engaged in trade or business in the foreign country. During his travels, there were no transactions in the foreign bank account. At the conclusion of his stay, the taxpayer requested the bank to reconvert the foreign currency to dollars and close his account. The value of the foreign currency, measured in terms of dollars, differed at the time the account was closed from the value when the account was opened. On these facts, the ruling concludes that the difference realized upon reconverting the foreign currency was a capital gain or loss.

The facts before this Court are similar to those in Rev. Rul. 74-7. AT&T, which is not a dealer in foreign currency, converted dollars into Canadian currency and conditionally deposited them in the Canadian treasury pending the outcome of its tax controversy with Canada. At the time of refund, the deposited Canadian dollars were sent to AT&T which reconverted them into United States dollars. The change in value of Canadian currency during the period AT&T's dollars were in the possession of the Canadian government results in a gain to AT&T upon the reconversion by it of the Canadian dollars into United States dollars. Under the principle of Rev. Rul. 74-7, AT&T's gain of $69,381.50 must be afforded current gain treatment.

In the case of Gillin v. United States, 423 F.2d 309 (Ct. Cl. 1970), taxpayer, a United States citizen, on five occasions from 1957 to 1960 borrowed a total of $260,268.91 Canadian dollars and immediately converted the loans into United States dollars. In 1961, the taxpayer repaid the loans in Canadian dollars which he had purchased for $240,758.15. The Court held that the taxpayer had realized a taxable ordinary gain on the theory that the gain resulted from a discharge of indebtedness. A separate concurring opinion held that the gain should be treated as capital gain resulting from a transaction in foreign currency. The principle of the Gillin case is applicable to the case at hand. AT&T is in the same position as Gillin except that, rather than borrowing Canadian dollars and repaying them at

a profit, AT&T, in effect, loaned Canadian dollars and was repaid at a profit. In either case, the total transaction yielded a profit as a result of currency fluctuation upon which AT&T is required to pay tax in the year of receipt.

Similarly, in the case of Willard Helburn, Inc. v. Commissioner, 214 F.2d 815 (1st Cir. 1954), a taxpayer had received a loan in foreign currency and repaid it in foreign currency. The dollar value of the currency received, converted at the rate of exchange on the date of the loan, exceeded the dollar value of the foreign currency repaid, converted at the date of repayment. The Court held that the difference in dollar amounts resulted in taxable income to the taxpayer. See also Bennett's Travel Bureau, Inc. v. Commissioner, 29 T.C. 350 (1957).

POINT II

AN AMBIGUOUS PROVISION IN THE INTERNAL REVENUE CODE, SECTION 905(c), MUST BE INTERPRETED IN A MANNER WHICH ENCOURAGES TAXPAYERS TO MINIMIZE THEIR FOREIGN TAX LIABILITY THEREBY INCREASING FEDERAL REVENUES

A. TAXPAYERS SHOULD NOT BE DISCOURAGED FROM SEEKING FOREIGN TAX REFUNDS

Section 905(c) of the Code provides that a taxpayer's liability shall be "redetermined" in the event that a previously credited foreign tax is subsequently refunded. In the typical case, a reasonable method of redetermination is that prescribed in Rev. Rul. 58-237 which is discussed in POINT I(B) above. The case before this Court for review, however, is not

a typical case. Its unique fact pattern presents a broad social policy question viz., should a Federal tax statute be interpreted in a manner that discourages taxpayers from seeking foreign tax refunds (an interpretation which only benefits foreign governments) or in a manner which gives taxpayers an incentive to seek foreign tax refunds. If the District Court opinion is correct in holding that the recipient of a foreign tax refund must remit every tax dollar refunded (including gain from currency fluctuation) to the IRS, taxpayers will no longer seek refunds of foreign taxes as they will be no better off than they were prior to the refund. Were this the rule, the Government would lose. If, on the other hand, a taxpayer receiving a foreign tax refund in excess of the original tax paid was permitted to report as current income the portion of the refund attributable to currency fluctuation, both the Government and the taxpayer would gain; the taxpayer would retain one-half of the currency gain (assuming a 50% tax rate) and the Government would receive the other half of the currency gain plus the entire refunded tax.

In discussing this argument, the District Court's opinion conceeds that under its interpretation of section 905(c) both the Government and the taxpayer stand to lose:

> "The instant and, I believe, correct interpretation of § 905(c) gives to a U.S. taxpayer who has paid a foreign tax which has been credited against his United States tax no incentive to seek any refund from that country, since whatever he receives must be handed over in full to the IRS. The virtue of ATT's

> proposed reading of § 905(c), on the other hand, is that a U.S. taxpayer would have an incentive to seek refund of a foreign tax since any gain resulting from an exchange rate fluctuation would be taxed only as a capital gain or ordinary income, and the taxpayer would be able to retain some portion of the refund. (In this case while ATT would have to pay the U.S. Government only part of the $69,381.50; it could keep the rest). Were this the rule both the Government and the taxpayer would gain. At present however, a taxpayer has no incentive to seek such a refund, as it is of no import to him, absent unusual patriotic impulses, since he stands to gain nothing for his efforts. However, these are policy considerations which are the responsibility of the legislature and not the courts to determine." (28A - 29A)

The District Court's finding that "these are policy considerations which are the responsibility of the legislature and not the courts to determine" begs the issue. AT&T did not request the District Court to rewrite legislative enactments to give effect to its concept of tax policy. Section 905(c) is silent on the proper method for redetermining tax liability in the event of a foreign tax refund. As Congress has chosen to remain silent, the Court has the responsibility to construe the statute in a manner that is consistent with the purposes and policies of the entire statutory scheme of which section 905(c) is a part. Philbrook v. Glodgett, 421 U.S. 707, 713 (1975); Chemehuevi Tribe of Indians v. F.P.C., 420 U.S. 395, 402-03 (1975). "It is a familiar maxim of statutory interpretation that courts should enforce a law so as to achieve its overriding purpose, even if the words of the

act leave room for a contrary interpretation." Rosenberg v. Richardson, 538 F.2d 487, 490 (2d Cir. 1976).

In Lenkin v. District of Columbia, 461 F.2d 1215 (D.C. Cir. 1972) (reversal of D.C. Tax Court denial of certain depreciation deductions) the Court noted that Congress had not spoken to the issue at bar. Since Congress had not specified its intent, the Court made a "projection" as to that issue, seeking to find an equitable conclusion to the controversy. Id. at 1228-29.

In Montana Power Co. v. Federal Power Commission, 445 F.2d 739 (D.C. Cir. 1970), cert. denied, 400 U.S. 1013 (1971), the Court was faced with an interpretation of § 10(e) of the Federal Water Power Act. The Court found that Congress had not expressly defined the applicability of that section to the precise issue at bar. In seeking to determine the scope of that statute, the Court held that it "must discern the applicable legislative intent by what is necessarily an act of projection - starting from the areas where the legislative intent is readily discernible, and projecting to fair and reasonable corollaries of that intent for the specific issue ...." Id. at 746.

The Court's duty in interpreting a statute is to discern how the legislature would have dealt with a problem if it had been contemplated. District of Columbia v. Orleans, 406 F.2d 957, 958 (D.C. Cir. 1968) (Action seeking refund of a local tax); United States v. Klinger, 199 F.2d 645, 648 (2d Cir. 1952), aff'd. 345 U.S. 979 (1953)(Criminal prosecution).

We submit that if Congress had contemplated the facts at bar, it would not have authorized the result which the defendant seeks to enforce, as it violates the overall statutory scheme of the Internal Revenue Code. "Generally, courts will not construe a section of an Act, in the absence of an unmistakable directive, in a manner which runs counter to the broad goals Congress sought to achieve." Farrell Lines Inc. v. United States, 499 F.2d 587, 598 (Ct. Cl. 1974). Since the entire purpose of the Internal Revenue Code is to produce revenue for the United States, the District Court's ruling which discourages taxpayers from seeking foreign tax refunds is inconsistent with that end. A taxpayer will have no incentive to seek a tax refund from a foreign government where he only stands to lose money because of the legal costs associated with claiming the refund. Moreover, the Government will find itself deprived of not only the excess portion of the refund attributable to currency fluctuation, but also the entire amount of any foreign tax which would have been refunded. Since one of the motives of United States public policy is to "secure an adequate revenue to sustain the public burdens, and discharge the public debts", United States v. Bank of North Carolina, 6 Pet. 29, 35 (1832), it seems beyond doubt that Congress, had it addressed the issue raised by this case, would have chosen an approach which results in a sharing of the benefits between the taxpayer and the Government, rather than an approach which as a practical matter

benefits only foreign governments who, in cases similar to the one at bar, will no longer be called upon by taxpayers to refund foreign taxes* See also Markham v. Cabell, 148 F.2d 737 (2d Cir. 1945) (L. Hand, J.), aff'd. 326 U.S. 404 (1945), where the Court stated that, "...it is one of the surest indexes of a mature and developed jurisprudence not to make a fortress out of the dictionary; but to remember that statutes always have some purpose or object to accomplish, whose sympathetic and imaginative discovery is the surest guide to their meaning." Id. at 739.

Notwithstanding the District Court's statement that "[t]he same general issue has been raised previously in other forums and in each case the result has been the same" (27A), the fact is that the narrow issue presented in this case has never been specifically dealt with in any case, administrative ruling or Congressional pronouncement. There is no precedent to dictate a particular result. It is truly a case of first impression. To rule other than in favor of AT&T would cause an absurd result unintended by Congress, to wit, discouraging United States taxpayers from seeking foreign tax refunds, a burden which ultimately must be borne by the Government.

B. WHERE THERE IS DOUBT AS TO THE APPLICATION OF A TAX STATUTE, A COURT MUST RESOLVE THAT DOUBT IN FAVOR OF THE TAXPAYER

The determination by the IRS as to the applicability

*Congressional policy is also violated because of the resulting double taxation as discussed in POINT I(A), supra p.8.

of section 905(c) to the facts before this Court is not controlling. The Courts are the final authorities on issues of statutory construction, Volkswagenwerk Aktiengesehlschaft v. Federal Maritime Commission, 390 U.S. 261, 272 (1968); Wisdom v. Norton, 507 F.2d 750, 757 (2d Cir. 1974), and "[r]eviewing courts are not obliged to stand aside and rubber-stamp their affirmance of administrative decisions that they deem inconsistent with a statutory mandate or that frustrate the Congressional policy underlying a statute." NLRB v. Brown, 380 U.S. 278, 291 (1964).

Tax statutes which are unclear and ambiguous must be construed in favor of the taxpayer. This well known rule of statutory construction was enunciated in the leading case of Gould v. Gould, 245 U.S. 151 (1917):

> "In the interpretation of statutes levying taxes it is the established rule not to extend their provision, by implication, beyond the clear import of the language used, or to enlarge their operation so as to embrace matters not specifically pointed out. In case of doubt they are construed most strongly against the Government, and in favor of the citizen." Id. at 153

The general rule of the Gould case has been followed consistently in all cases in which that issue has been raised. See United States v. Brown, 536 F.2d 117, 122 (6th Cir. 1976); Allstate Insurance Co. v. United States, 530 F.2d 378, 384 (Ct. Cl. 1976); Greyhound Corporation v. United States, 495 F.2d 863 (9th Cir. 1974).

In the case before this Court for review, the tax statute, section 905(c), is unclear and ambiguous; hence, under the Gould doctrine its interpretation should favor the taxpayer. Ironically, a statutory construction which favors AT&T also favors the Government, whereas one that does not favor AT&T results in both AT&T and the Government losing.

CONCLUSION

For the reasons given above, we respectfully request that the order of the District Court, entered on April 18, 1977 granting defendant's motion for summary judgment, be reversed, and that judgment be awarded to plaintiff-appellant.

Dated: New York, New York
August 2, 1977

Respectfully submitted,

FRANK L. FULLER III
VICTOR S. GOMPERTS
195 Broadway
New York, New York 10007
(212) 393-4083

Attorneys for Plaintiff-Appellant

A 202 Affidavit of Personal Service of Papers — LUTZ APPELLATE PRINTERS, INC.

COURT OF APPEALS
SECOND CIRCUIT

AMERICAN TELEPHONE AND TELEGRAPH COMPANY,
Plaintiff-Appellant,

- against -

UNITED STATES OF AMERICA,
Defendant-Appellee,

Index No.

Affidavit of Personal Service

STATE OF NEW YORK, COUNTY OF *ss.:*

I, James A. Steele *being duly sworn, depose and say that deponent is not a party to the action, is over 18 years of age and resides at* 112 West 136th Street; New York, New York

That on the 2nd *day of* J August *19* 77 *at* One St. Andrews Plaza New York, New York *upon*

deponent served the annexed

Appendix Brief

Thomoseley
Thomas Moseley. U.S. Atty.

the *in this action by delivering a true copy thereof to said individual personally. Deponent knew the person so served to be the person mentioned and described in said papers as the* *herein,*

Sworn to before me, this 2nd *day of* Aug. *19* 77

James A. Steele

James A. Steele

ROBERT T. BRIN
NOTARY PUBLIC, State of New York
No. 31 0418950
Qualified in New York County
Commission Expires March 30, 1979